DEPARTMENT OF GENERAL SERVICES

POLICY TITLE: Internal Use Software
POLICY NUMBER: FS-11
REVISION NUMBER: N/A
APPROVED BY: Richard F. Sliwoski **, DGS Director**

DATE: 01/15/09
EFFECTIVE DATE: 07/01/08

I. PURPOSE

The purpose of this policy is to outline the accounting treatment for internal use software expenditures.

II. REFERENCES

- *CAPP 30210 Acquisition Valuation*
- *CAPP 30305 Capitalized or Controlled Assets*
- *CAPP 31200 Fixed Asset and Lease Accounting*
- *AICPA EITF Issue No. 3 on SOP 97-2 Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*
- *AICPA SOP 98-1 Accounting for Costs of Computer Software Developed or Obtained for Internal Use*
- *FASB SFAS 86 Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*
- *FASAB SFFAS 10 Accounting for Internal Use Software*

III. DEFINITIONS

For purposes of this policy and related procedures, the terms are defined as follows:

Software (Construction) in Progress — A balance sheet classification which represents a temporary capitalization of labor, materials, and equipment of buildings or other fixed assets (capital projects) that are under construction.

Internal Use software — Software that is purchased from commercial vendors "off the shelf" (COTS), internally developed, or contractor-developed solely to meet the agency's internal or operational needs. For the purposes of this policy guidance and in accordance with SFFAS 10, internal use software includes:

- Internally developed software that employees of the agency actively develop, including new software and existing or purchases software that are modified with or without a contractor's assistance.
- Contractor-developed software that the agency pays a contractor to design, program, install, and implement, including new software and the modification of existing or purchased software.

License — A per unit or concurrent unit right to use software.

Maintenance Fee	Service charge assessed, typically based on the number of licenses, for the vendor to support or keep the software functioning as intended (i.e., maintain the software).
Software	An application and operating system programs, procedures, rules, and any associated documentation pertaining to the operation of a computer system or program.

IV. POLICY

It is the policy of DGS to account for cost incurred to acquire, develop, maintain, or enhance internal use software in accordance with the guidelines referenced above.

- Information System Services (ISS) shall provide the software costs incurred and meeting the classification described in this policy document as internal use software to Fiscal Services.
- Divisions shall assist ISS in the accumulation and determination of the purpose and/or nature of the software costs incurred (e.g., bug fix, enhancement, minor/major upgrade) and whether title passes with acquisition of the software.
- Fiscal Services shall perform FAACS and LAS entry as appropriate based on the costs provided.

V. RESPONSIBLE DIVISION/STAFF DIRECTOR

DGS Controller will be responsible for making revisions to this policy as necessary.

VI. CONTACT POSITION FOR INTERPRETATION

DGS Controller, Fiscal Services, (804) 786-7925

VII. POLICIES SUPERSEDED

Not applicable.

VIII. EXCEPTIONS

Exceptions to this policy shall be made on a case-by-case basis as approved by DGS Director and/or DGS Controller.

IX. PROCEDURES

A. LICENSES, MAINTENANCE FEES, SERVICE CONTRACTS

1. DGS shall *not* capitalize software licenses or maintenance fees incurred to use or maintain software.

   a. Software licenses; however, can cover periods ranging from the entire estimated service life of the software ("perpetual license") to annual or more frequent periods and are considered to be similar to leases. In such cases, lease accounting concepts shall govern. However, the agency has determined that though a license may be considered to be a "perpetual license" where lease accounting concepts would apply, if the amount of the license is immaterial (e.g., less than 5%) to the agency's financials – the cost of such license shall be expensed.

2. DGS shall *not* capitalize multi-year service contracts. Multi-year service contracts may include hosting arrangements. If a contractual right to take possession of the software during the hosting period without significant penalty exists and it is feasible for the agency to run the software on it own hardware or contract with another party unrelated to the vendor to host the software, the contract will be evaluated further and the costs associated with this arrangement may be capitalized.

3. DGS shall evaluate software license and multi-year service contracts that are similar to leases in accordance with the Commonwealth's lease capitalization criteria to determine whether payments for such shall be capitalized:

   a. In general, in order for a lease to be classified as a capital lease, it must meet one of the following criteria:

      - Lease transfers ownership to the lessee at the end of the lease term
      - Lease contains a bargain purchase option
      - Lease term is equal to 75% or more of the estimated useful life of the leased asset
      - Present value of the minimum lease payments (reduced for executory costs and profit) equals

or exceeds 90% of the fair value of the leased asset

B. INTERNALLY DEVELOPED SOFTWARE

1. DGS *shall* capitalize all *development costs* incurred (both direct and indirect) to internally develop software as long as costs incurred meet or exceed the Department of Accounts (DOA) agreed upon Fixed Asset Accounting and Control System (FAACS) capitalization threshold of $50,000 for DGS internally developed or contractor developed software.

   The cutoff for capitalization of these costs shall be at the successful completion of acceptance testing of the software. Cost incurred after final acceptance testing shall be expensed.

C. COTS SOFTWARE

1. DGS *shall* capitalize the amount paid to the vendor to acquire title or copyright (not license) to COTS software as long as costs incurred to acquire the software meet or exceed the Fixed Asset Accounting and Control System (FAACS) capitalization threshold of $5,000.

2. DGS *shall* also capitalize internal application development costs incurred by the agency to implement the COTS and otherwise make it ready for use.

D. CONTRACTOR DEVELOPED SOFTWARE

1. DGS *shall* capitalize the *development costs, that is*, the amount paid to the contractor to design, program, install, and implement software developed by contractors as long as costs incurred meet or exceed the Department of Accounts (DOA) agreed upon Fixed Asset Accounting and Control System (FAACS) capitalization threshold of $50,000 for DGS internally developed or contractor developed software.

   The cutoff for capitalization of these costs shall be at the successful completion of acceptance testing of the software. Cost incurred after final acceptance testing shall be expensed.

2. DGS *shall* also capitalize internal costs incurred by the agency to implement the contractor-developed software and otherwise make it ready for use.

E. DEVELOPMENT COSTS

For the purposes of internally developed and contractor developed software, project costs are divided into three stages:

- the preliminary project stage
- the application development stage
- the post implementation operation stage

Only costs that are associated with the application development stage (i.e., *development costs*) are to be capitalized.

1. DGS *shall not* capitalize cost incurred in the Preliminary Project Stage. These are costs incurred prior to the commencement of application development and include:

   - requirements gathering, definition, and analysis
   - conceptual formulation of alternatives
   - evaluation of alternatives
   - determination of existence of needed technology
   - final selection of alternatives

2. DGS *shall* capitalize costs incurred in the Application Development Stage. These are costs incurred, both internal and external costs, to develop the software and include:

   - design of chosen path
   - software configuration
   - software interfaces
   - coding/programming
   - installation to hardware
   - testing (e.g., unit, system, acceptance, integration, and volume to include parallel processing)

a. DGS *shall* capitalize direct costs of materials and services consumed in developing or obtaining software, such as fees paid to third parties for services and costs incurred to obtain software from third parties.

b. DGS *shall* capitalize internal costs to include payroll and payroll related (benefits) costs of employees who are directly associated with and who devote time to the internal use software project. Travel expenses incurred by employees in their duties directly associated with developing the software *shall* be capitalized. However, general and administrative costs and overhead costs *shall not* be capitalized.

The Application Development Stage ends with the successful completion of user acceptance testing when the software is ready for use.

3. DGS *shall not* capitalize cost incurred in the Post-Implementation Operation Stage. These costs include:

- training
- application maintenance

4. DGS *shall not* capitalize the cost of reengineering activities or Y2K modifications.

F. DATA CONVERSION COSTS

1. DGS *shall not* capitalize data conversion costs. Data conversion process costs include:

- Purging or cleansing existing data
- Reconciling or balancing old data to data in new system
- Creation of new/additional data
- Conversion of old data to new system

All data conversion costs incurred for internally-developed, contractor developed, or COTS software *shall not* be capitalized and should be expensed.

2. DGS *shall* capitalize the cost incurred to acquire, purchase, or obtain tools or other software (e.g., Informatica) to access or convert data from the old system to the new system as long as the cost incurred to acquire the software meets or exceeds the FAACS capitalization threshold.

G. UPGRADES & ENHANCEMENTS

Upgrades and enhancements normally require new software specifications and change to all or part of existing software specifications.

1. DGS *shall* capitalize or expense cost incurred for upgrades and enhancements as follows:

   a. The cost of upgrades or enhancements to existing internal use software *shall* be capitalized when it is more likely than not that it will result in *significant additional capabilities or functionality.*

   b. The cost of minor upgrades or enhancements resulting from ongoing maintenance or even major upgrades or enhancements that merely extend the useful life or capacity of the software *shall not* be capitalized and shall be expensed. The purchase of enhanced versions of the software for a *nominal* charge shall also be expensed.

   In summary, software costs that:

   - adds capability/functionality = CAPITALIZED
   - extends the useful life or capacity = EXPENSED

H. CAPITALIZATION

1. DGS *shall* apply the Commonwealth's FAACS capitalization threshold of $5,000 or more in determining whether COTS or purchased software costs should be capitalized.

2. DGS *shall* apply the DGS-requested and DOA-agreed upon capitalization threshold of $50,000 or more in determining whether internally developed or contractor developed software costs should be capitalized

3. DGS *shall* determine the useful life of each application as estimated by Information Systems Services with assistance from the responsible division or owner of the software where necessary.

4. DGS *shall* amortize / depreciate internal use software costs using a straight-line or units of production/transaction method (i.e., a systematic, rational manner) over the useful life of the software.

5. DGS *shall* consider software as impaired if one of the following occurs, either while the software is being developed or is currently in use:

   a. Software is not expected to provide substantive service potential or any service potential

   b. A significant change occurs in the extent or manner in which the software is or is expected to be used

   c. A significant change is made or will be made to the software

   d. Costs of developing or modifying the software significantly exceed the amount originally expected to develop or modify the software

   e. Its no longer probable that software being developed will be completed and placed in service which may be indicated by the following:

      - Lack of expenditures to budgeted or incurred for project
      - Programming difficulties that can not be resolved in a timely manner
      - Significant cost overruns
      - Information exist to support that costs of the software will significantly exceed costs of comparable 3rd party software such that management plans to obtain 3rd party software

   DGS *shall* notify DOA of any impairment to software as soon as possible so that the appropriate accounting treatment may occur in FAACS for the impaired software.

I. FAACS & LAS ENTRY

1. DGS *shall* accumulate *only development costs* incurred for internally developed or contractor developed software meeting the capitalization threshold above in a Construction-in-Progress temporary asset account. The costs accumulated must meet or exceed the capitalization threshold described above.

2. DGS *shall* enter or update costs incurred (whether internally or by a contractor or both) at least *quarterly* into the Fixed Asset Accounting and Control System as Construction-in-Progress (CIP) until which point acceptance testing of the software is considered complete and the software ready for use.

3. DGS *shall* convert costs accrued in the CIP account to an Internal Use Software (PPE) asset account upon successful acceptance test of the software and the software is deemed ready for use. Amortization/depreciation of the asset *shall* commence at this time.

4. DGS *shall* enter amounts paid to acquire title or copyright (not license) to COTS internal use software into FAACS in the appropriate Internal Use Software (PPE) asset account. Amortization/depreciation of the asset *shall* commence at this time.

5. DGS *shall* enter leased software meeting the criteria to be deemed to be a capital lease into FAACS and recorded in the appropriate Lease asset account based on the net present value of the lease payments into LAS.

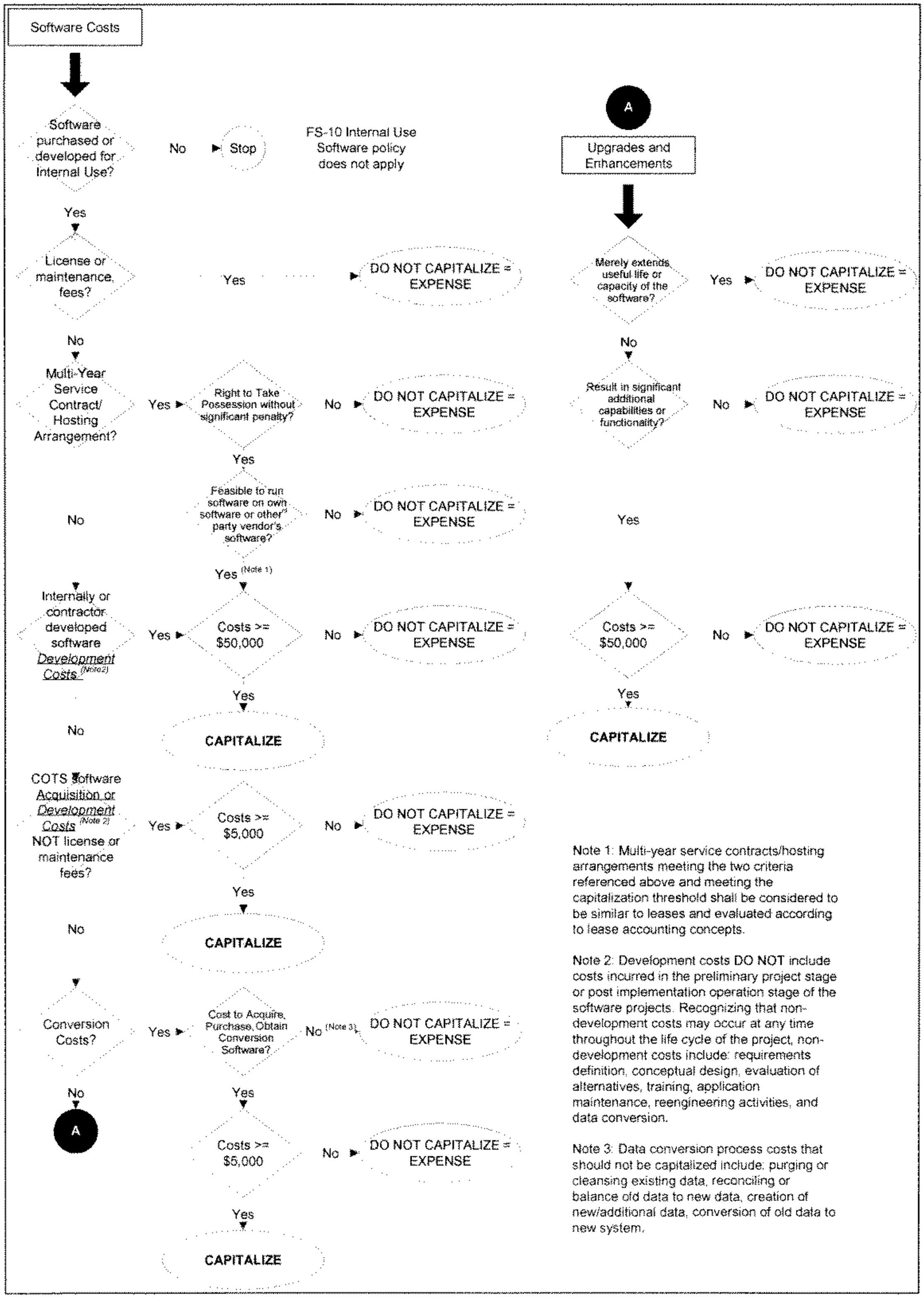
J. TOOLS

1. DGS *shall* use as a guide the decision tree represented in Appendix A. Completion of the checklist will assist agency personnel in applying the above guidelines and taking into account the considerations. It will also help Fiscal Services determine the appropriate accounting treatment for the Internal Use Software.

X. EFFECTIVE DATE, DISTRIBUTION METHOD, AND EXPIRATION DATE

This policy shall be distributed through normal distribution channels. It shall be effective July 1, 2008 for 7 years expiring on July 1, 2015.

APPENDIX A – INTERNAL USE SOFTWARE DECISION TREE



Note 1: Multi-year service contracts/hosting arrangements meeting the two criteria referenced above and meeting the capitalization threshold shall be considered to be similar to leases and evaluated according to lease accounting concepts.

Note 2: Development costs DO NOT include costs incurred in the preliminary project stage or post implementation operation stage of the software projects. Recognizing that non-development costs may occur at any time throughout the life cycle of the project, non-development costs include: requirements definition, conceptual design, evaluation of alternatives, training, application maintenance, reengineering activities, and data conversion.

Note 3: Data conversion process costs that should not be capitalized include: purging or cleansing existing data, reconciling or balance old data to new data, creation of new/additional data, conversion of old data to new system.